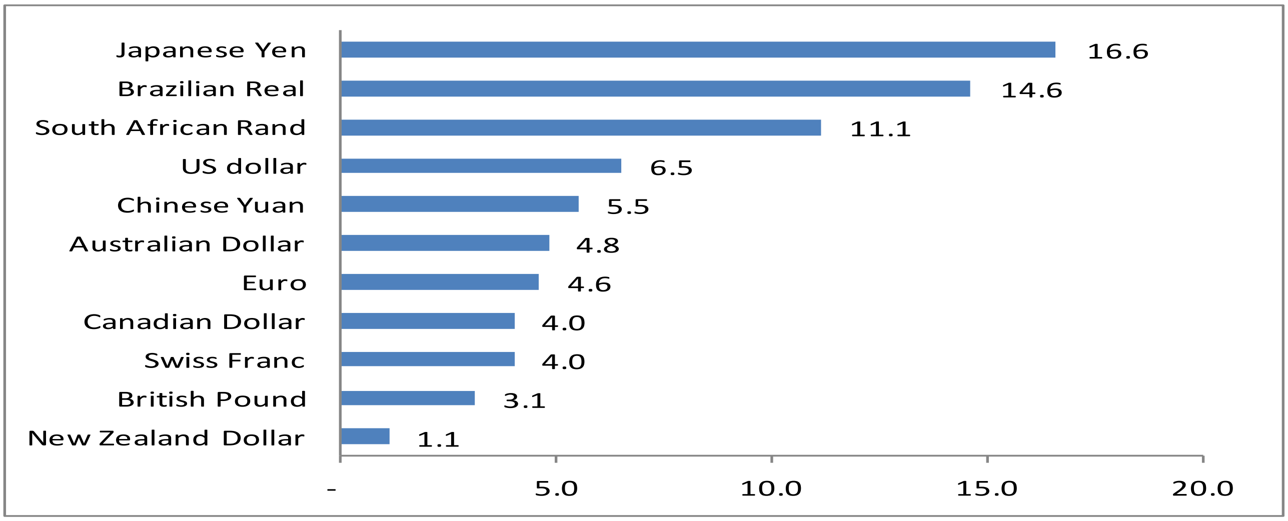
Philequity Corner (December 31, 2012)
By Valentino Sy

Is the Peso too Strong?

The Philippine peso closed 2012 at its strongest level in five years - evidence of the country's much improved economic fundamentals. The peso strengthened 6.5 percent against the US dollar year-on-year, ending 2012 at 41.005. Spurred by confidence in the Aquino government, accelerating economic growth, strong OFW remittances and BPO revenues, sharp increase in the current account surplus and record GIR, the peso beat almost all the major currencies.

Peso vs. Major Currencies

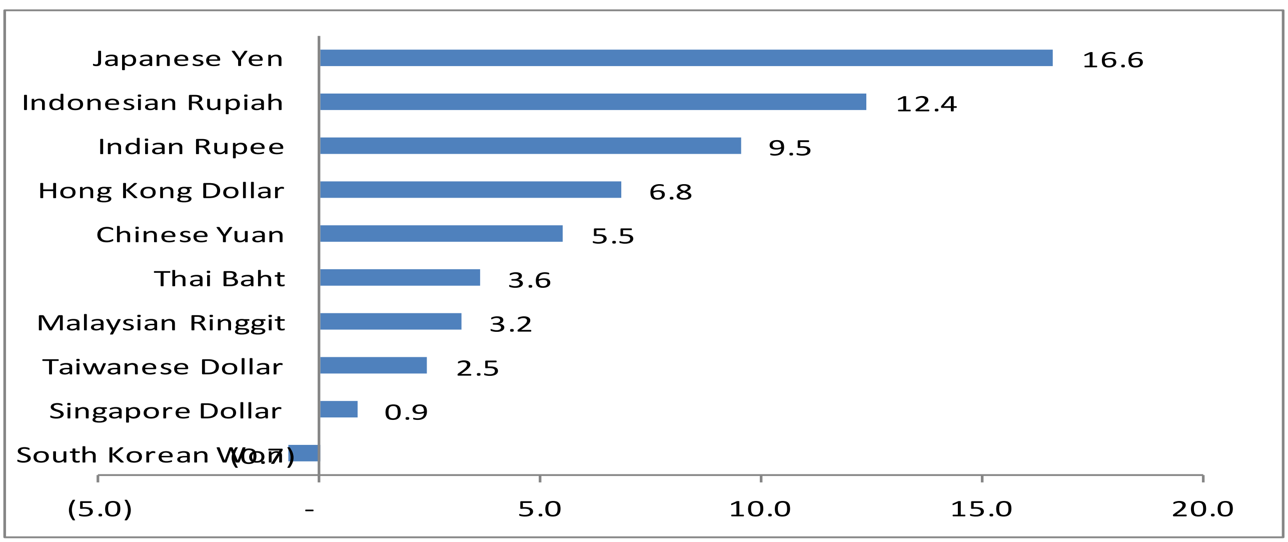
As seen below, the peso strengthened against all major currencies in 2012. The peso appreciated 16.6 percent against the Japanese yen, 6.5 percent against the US dollar, 5.5 percent against the Chinese yuan and 4.6 percent against the euro.



Source: Bloomberg

Peso vs. Asian Currencies

The peso appreciated against all Asian currencies, except for the Korean Won. Note, however, that the peso strengthened against the Indian rupee by 9.5% in 2012 and by a total of 30% the past 2 years.



Source: Bloomberg

The Great Global Monetary Easing

Another major reason for the peso's strength is due to the excess liquidity worldwide. In 2012, major central banks such as the FED, ECB, BOE and BOJ have stepped up their quantitative easing (QE) programs to stimulate their respective economies (see *The Great Global Monetary Easing,* October 22, 2012). New money is injected by central banks to purchase assets from commercial banks and private institutions in a bid to keep interest rates at ultra-low levels. Some of this new money eventually ended up in emerging markets like the Philippines in the form of portfolio inflows.

Currency Wars

An offshoot of QE is currency wars because of competitive devaluation that usually accompanies it. Most economies want their net exports to improve given the anemic domestic demand.

To counter these currency wars and at the same time stimulate their own respective economies, other central banks from countries such as China, India, Brazil and Australia likewise lowered their respective interest rates. The Philippines did its part with the Bankgo Sentral ng Pilipinas (BSP) cutting benchmark rates 4 times this year down to 3.5 %.

BPOs may lose competitiveness

In our past articles, we warned about the danger of excessive peso strength and its negative long-term economic impact if left unchecked. In one of these articles, when the peso has just breached the 42 level against the US dollar, we mentioned that further peso strength is worrying especially for the Business Process Outsourcing (BPO) sector.

"What's more alarming for us in Philequity is how the peso has appreciated against the Indian rupee since the 2nd half of 2011 which may have a big impact on our BPO sector where India is our primary competitor… The rupee is now cheaper by almost 30% compared to the peso." - (see *Too Much of a Good Thing*, July 9, 2012)

Last week, the Business Process Association of the Philippines (BPAP) also warned that the steadily rising peso is already eroding their competitiveness and could threaten their ability to expand.

Calls for capital control

The strong appreciation of the peso this year has prompted calls for new measures aimed to deal with "speculative" capital inflows and excessive volatility in the foreign exchange. Even IMF, which has been vocal against capital controls in the past, has indicated its willingness to relax its stance. In a recent policy paper, the IMF recommended capital control to address the surge in capital inflows that may destabilize economies thru formation of asset bubbles.

BSP's prompt response

Always on top of the situation, the BSP responded by imposing new limits on non-deliverable currency forwards (NDFs) to temper speculative inflows. This is comparable to what Korea did starting December 1 to address a similar problem. The BSP now caps local banks' NDF exposure to 20% of capital and foreign banks' exposure at 100% of capital. The cap essentially makes speculating in NDF harder and therefore discourages speculation.

Antonio Moncupa, Jr., president of East West Bank and chairman of the Open Market Committee of the Bankers Association of the Philippines (BAP) said that the BAP is amenable to the new measure. *"We respect the BSP's position. The BSP is in command of data which no one else has. Their agenda is much bigger than any bank,"* he was quoted as saying.

Earlier this year, the BSP has already banned overseas investors from its special deposit accounts (SDAs) and ordered lenders to provide more funds to cover risks on non-deliverable currency forwards.

A rosy 2013

Overall, we see positive things happening to the Philippine economy and the Philippine stock market in 2013. With the continued slowdown in the West, we see more QE coming from the US, the EU, Japan and UK which means that the global interest rate environment should remain low. Inflation is also expected to remain low with the BSP targeting 4% for 2013-2014.

The recent passage of the Sin Tax bill and the RH bill has also received very positive response from investors. Not only does it improve the country's credit outlook but it affirms the Aquino government's ability to pass key structural reforms. Thus, the expected credit upgrade in 2013 would mean more investments coming to the Philippines. Furthermore, the revenues generated from the Sin Tax bill and other revenue reforms can then be used to accelerate investment spending, thus ensuring the higher growth trajectory for the Philippine economy.

Too much of a good thing can be a problem

"*Managing the peso will become more challenging in 2013 given that the Philippines would likely reach investment grade by then*," according to BSP Deputy Gov. Diwa Gunigundo. So far, the government is doing all the right things. But the BSP is correct in saying that we have to watch out for the peso and the excessive volatility and damage to the economy that a deluge of "fickle" hot money may bring. Too much of a good thing can also turn out to be a problem.

In this case, we believe that more forex measures or capital control may be warranted in the future. Recent moves of global central banks which came out with innovative and unconventional measures like the Fed's QE, ECB's OMT and Japan's Asset Purchase Program will justify similar unconventional measures from our BSP.

If the BSP is not proactive, the peso may become too strong which will leave our industries, especially the exporters and the BPOs, uncompetitive. While an excessively strong peso may lift asset prices, ultimately, it will not be good for the economy.

Learning from Japan

The Philippines should learn from what happened to Japan which is now trying to weaken the yen under the leadership of Shinzo Abe. Due to a strong yen in past years, many of Japan's exporters became unprofitable and lost market share to competitors like South Korea. Meanwhile, the Japanese stock market stagnated and has lost almost 80 percent in value since it peaked in Dec. 1989. Its economy never recovered in what is known as Japan's lost decade.

PSEi target of 6,700 for 2013

2012 was another good year for Philippine stocks. The PSE index reached our upgraded year-end target of 5,800 on the dot (see *Italy defeats Germany*, July 2, 2012) for a 32.95% return. We are proud to say that our flagship Philequity Fund beat the index again with a return of 33.69% for the year.

For end-2013, we expect the PSE index to hit 6,700. Our key assumptions and computations will be discussed in subsequent articles and during our investors briefing.

We wish our shareholders and readers a prosperous New Year!

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